

Committee on Resources,

Subcommittee on Energy & Mineral Resources

[energy](#) - - Rep. Barbara Cubin, Chairman

U.S. House of Representatives, Washington, D.C. 20515-6208 - - (202) 225-9297

Witness Statement

Testimony of John A. Harpole
President
Mercator Energy LLC
Before the House Subcommittee on Energy and Mineral Resources
House Committee on Resources
On Collection and Disposition of Federal Oil and Gas Royalties Taken In-Kind
June 12, 2001

Introduction

Madam Chairwoman and members of the Committee: I am John Harpole, President of Mercator Energy. Mercator Energy is a natural gas services consulting company based in Denver, Colorado that provides marketing services to both natural gas end-user and natural gas producing customers. In the mid-1980's, the Federal Energy Regulatory Commission (FERC) created open-access transportation on interstate natural gas pipelines via FERC Order 436. At that time, I was employed by an oil and gas production company owned by General Electric. As a result of FERC Order 436, I was put in charge of supplying natural gas to 55 General Electric industrial plants behind 34 utilities and 18 interstate pipelines. It may also be of interest to you, Madam Chairwoman, to note that my company marketed all of the natural gas production out of the Jonah Field in Sublette County, Wyoming, for McMurtry Oil Co. from 1992 to 2000. Those varied experiences have provided me with an extensive view of the natural gas industry -- from the wellhead to the burnertip.

Additionally, I have served as Vice-Chairman of the Natural Gas Committee of the Independent Petroleum Association of America and on the governing boards of two regional producer trade associations, the Colorado Oil and Gas Association and the Independent Petroleum Association of Mountain States. Over the last twelve years, I have authored articles about a number of timely issues affecting the natural gas industry for such publications as American Oil & Gas Reporter, Oil and Gas World, Hart's Energy Markets, and Natural Gas Focus. Although I have testified before FERC, this is my first opportunity to testify before Congress.

I am here representing myself and my company, an independent, regional natural gas consulting firm, not an industry organization or political entity. My participation is the result of my interest in seeing the idea that I will describe further herein, reach fruition. While the resulting program should provide opportunities for positive public relations and increased public awareness of how the natural gas industry "works", my true goal is to help author an efficient solution for low- and fixed-income individuals who have been and continue to be hurt by rising natural gas prices.

Last month, President Bush's National Energy Policy Development Group specifically recommended that the President "...take steps to mitigate impacts of high energy cost on low-income consumers", including

"...directing the Secretaries of the Interior and Health and Human Services to propose legislation to bolster LIHEAP [Low Income Home Energy Assistance Program] funding by using a portion of oil and gas royalty payments" and "...redirecting royalties above a set trigger price to LIHEAP, whenever crude oil and natural gas prices exceed that trigger price, as determined by the responsible agencies." (Chapter 2, page 2-12)

Today, I appear before you to describe and explain the efficiencies of a novel concept to expand existing low-income energy assistance programs by taking federal royalty gas in-kind and allocating that gas directly to pre-qualified low-income energy assistance needs. On February 7, 2001, Colorado Governor Bill Owens sent a letter to Vice President Cheney's office outlining the general terms of the concept. That letter resulted in press coverage from a number of natural gas industry trade publications. I have attached copies of the letter from Governor Owens and the response from Vice President Cheney's office as exhibits to this testimony.

After the effort that a number of parties contributed to this concept, it was gratifying to see the National Energy Policy Development Group select it for inclusion in the policy document that was released last month. As evidence of the bi-partisan support this concept has received, a variation of this idea was introduced in the House of Representatives on March 8, 2001 by Carol Maloney, (D-NY) as HR962, and a similar bill in the Senate by Charles Schumer (D-NY) and Hillary Rodham Clinton (D-NY).

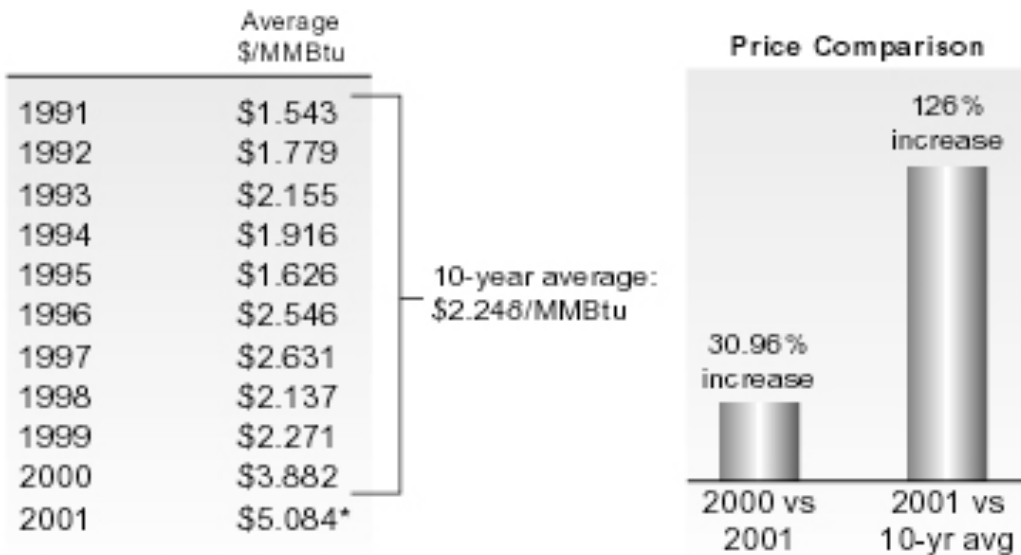
The Need

This Committee is certainly aware of the dramatic increase in natural gas prices during the last 12 months. Most experts agree that the two major driving forces behind the price increase were the following:

1. a wholesale shift from coal to natural gas as the fuel of choice by electric utilities. This change is a result of stricter federal air quality standards for coal-fired power plants.
2. the exploration and production communities' inability to keep pace with increases in demand which has been exacerbated by more restrictive federal land access and right-of-way regulations.

We, as a country, cannot simultaneously restrict coal-fired electric generation emissions, access to federal lands, waters, and right-of-ways, and not expect a resultant increase in natural gas prices. Recent federal policy and regulations have contributed significantly to the recent surge in gas prices. If the federal government decides to pursue the concept I am proposing, the irony of a federal solution that would address the needs of those individuals most severely impacted, -- that is, those with low or fixed incomes -- might not be lost on the American public.

In an effort to convey the dramatic price increase, I have prepared an illustration that shows the average gas prices from 1991 to 2001.

NYMEX Natural Gas Prices

* Based on actuals for January-June and July-December NYMEX futures as of 6/6/01.

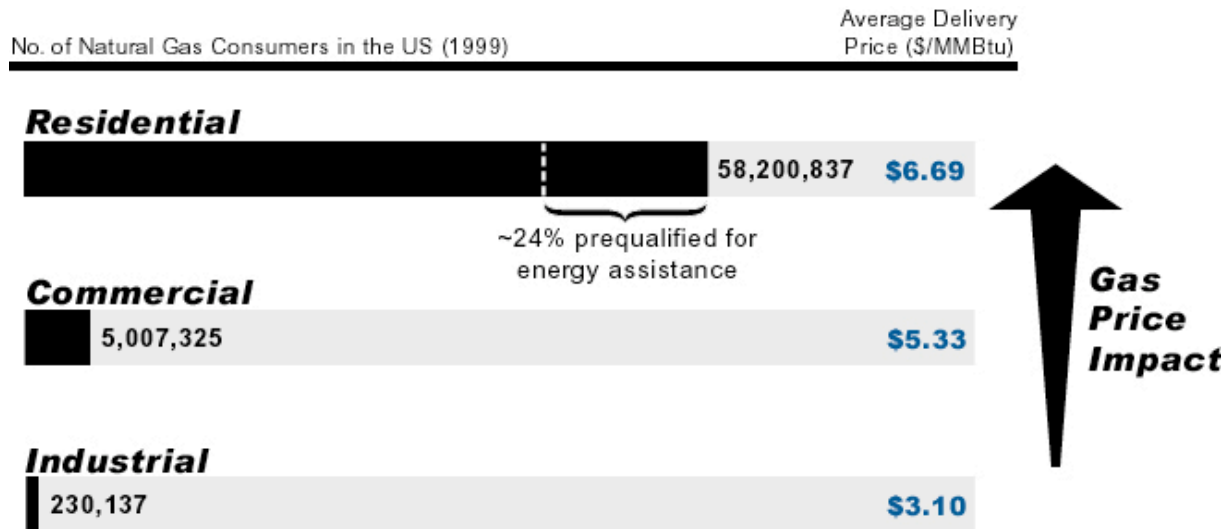
All three sectors of the natural gas customer base have been dramatically impacted by the price increase. Unlike their industrial and commercial counterparts who can lock down gas prices either physically or financially, residential customers – the largest consumer sector -- who rely on utilities to supply their natural gas, do not have access to individually-negotiated fixed-price contracts or any other type of long-term, fixed-price hedging tools. In fact, as a result of various state public utility commission rulings, regulated utilities generally are allowed to pass through the actual cost of natural gas to residential customers, regardless of what the price may be. However, the utilities are not allowed to earn a rate of return on the commodity portion of those pass-through gas charges. If they were allowed to do so, simple logic would dictate that the more they paid and charged for gas, the higher the utility's rate of return would be.

Furthermore, most utilities have no incentive to try to predict or "outguess" the forward price for natural gas by locking down long-term, fixed-price contracts for their residential customer base. Utilities face the 20-20 regulatory hindsight of state public utility commissions whenever commodity prices increase. Many of those utilities, instead, buy gas for their residential customer base under contracts that are tied to a monthly spot-price index. Utilities have found themselves in a no-win situation. There is no incentive to pursue the absolute lowest prices available, and their purchasing strategy is constantly second-guessed when higher prices occur. This situation results in a purchasing methodology relegated to a laissez-faire monthly spot-market price. Many public utility commissions are now rethinking purchasing policies as a result of the recent dramatic natural gas price increase.

Because of the trend toward spot-market purchasing, most residential customers are what natural gas derivative traders refer to as "naked the forward price" for natural gas. The spot market purchasing strategy provides tools for commercial and industrial customers to mitigate the impact of volatile pricing, but residential customers remain vulnerable. The financially "naked" residential natural gas customer is too often the one turning off the thermostat and throwing on the extra blankets.

The irony of all this is apparent in the illustration below. Residential gas consumers in this country total about 58 million, more than ten times the number of commercial customers and 250 times the number of industrial customers. Yet residential customers are those most severely impacted by gas prices. In sheer

numbers, the 58 million residential customers are the voting public, and consequently, they can drive public policy on an issue that they rarely have control over. Of those 58 million residential customers, 13.8 million qualify for LIHEAP assistance.



Source of data: U.S. Department of Energy, Energy Information Administration, *Summary Statistics for Natural Gas in the United States, 1995-1999*.

LIHEAP

"The Low Income Home Energy Assistance Program (LIHEAP) was created under the Omnibus Budget Reconciliation Act of 1981 (OBRA) to help low and fixed income households pay their fuel and utility bills. LIHEAP funding is allocated by the Department of Health and Human Services (HHS) and administered by the states, with the states having maximum flexibility in directing program funds.

"LIHEAP is one of the original seven block grants authorized by OBRA. Over the last decade, the LIHEAP program has evolved from providing only financial assistance to low-income households to today's efforts that include residential weatherization and home-energy repair. ...[under the program] states are given the flexibility to direct program funds as needed, allowing individual states to tailor programs according to the needs of its low and fixed income residents. In addition, states are required to maintain administrative expenses at or below *ten percent* [of the total allocated dollars], ensuring that most of the monies go directly to needy households. ... Finally, LIHEAP serves as discretionary, in many cases one-time, assistance providing a bridge that helps the working poor and avoiding dependence on welfare programs." (LIHEAP Issue Brief #1998-04)

According to the qualification criteria set forth by the federal LIHEAP program, approximately 24% of the country's 58 million residential customers qualify for energy assistance. LIHEAP assistance is available to households whose annual income is 150% of the federal poverty level or 60% of the state median income. As you can well expect, the number of applicants increased dramatically in conjunction with the natural gas price increase over the last heating season. Nearly 70% of the households receiving LIHEAP assistance in 1995 survived on an annual income of less than \$8,000. Nearly 34% of those households had at least one member 60 years of age or older. In addition to low-income households, senior citizens and individuals on fixed-incomes have been especially impacted by high natural gas costs.

The Source

The federal government is the largest natural gas producer in the United States. When royalty volumes from every onshore and offshore well are aggregated, the volume of daily production owned by the federal government exceeds that of the country's largest commercial natural gas producer. In 1999, the federal government received \$2.1 billion in total revenues from onshore and offshore natural gas royalty payments paid individually each month by each natural gas "wellhead operator". Based upon actual NYMEX natural gas settlement prices for the first six months of 2001 and the projected NYMEX futures prices for the remainder of this year, the federal government should receive nearly \$6 billion in royalty payments in 2001.

The federal government, through the Minerals Management Service (MMS), currently takes *in-kind* approximately 400,000 MMBtu per day of its total 2.5 million MMBtu per day of offshore royalty gas. That is, the federal government sells the gas itself rather than relying on a sale by the wellhead operator. The administration of this program and its associated costs and benefits represent a true success story within the Department of Interior. Fewer than 14 employees at the MMS sell the 400,000 MMBtu per day of gas in the open market on a monthly basis. The federal government also manages a successful onshore oil royalty-in-kind program in the state of Wyoming.

By any standard, the royalty revenues received in 2001 by the government can be considered a windfall for the federal treasury and for the onshore states that receive a 50% share of these onshore royalty revenues. Rather than see that windfall "disappear" into federal and state treasuries, why not incorporate those dollars in a solution for the needy?

One Approach

Most, if not all, utilities in the eastern United States have arranged for long-term natural gas supplies from producers in the Gulf of Mexico. As you are aware, the federal government, under the terms of federal leases granted to exploration and production companies, has the option to receive a one-sixth royalty payment on production located in offshore waters or take the equivalent volume of gas in-kind.

Nearly every utility in the western half of the country acquires a portion of its natural gas supplies from production located on federal lands in the Rocky Mountains. On those lands, the federal government receives a one-eighth royalty payment and also retains, under its lease agreements, the option to receive its royalty in-kind.

In the majority of cases, whenever a utility purchases gas from producers with production on federal lands, the utility utilizes its own transportation contracts on interstate pipelines in order to effectuate the transportation of gas "from the water" (Gulf of Mexico) or from "The Rockies" to their utility's front door, the "citygate."

As an example, KeySpan Corporation, the country's fifth largest gas utility and the largest gas utility in the Northeast, serves 2.4 million customers in three states. On an average January "peak" usage day, KeySpan consumes 1,100,000 MMBtu in its New York City service territory alone.

In January of 2000, in KeySpan's New York City service territory, 54,000 pre-qualified residential low-income customers accounted for a "low-income average daily demand" of 8200 MMBtu per day. Obviously the 8200 MMBtu per day of usage related to low-income demand is just a fraction (seven-tenths of one percent) of the total volume of gas consumed in New York City by KeySpan customers. The "low-income

volume" was calculated by identifying the LIHEAP recipients by account number and totaling the daily usage for each account. That aggregate demand volume obviously changes each month. Note that the "low-income volume" for KeySpan's New York City service territory of the largest gas utility in the northeast amounts to less than three-tenths of one percent (0.3%) of the federal government's total offshore royalty gas volume.

One of KeySpan's many purchase contracts calls for delivery of gas from an offshore Gulf producer in the amount of approximately 60,000 MMBtu per day. That volume is then transported by KeySpan under a firm transportation agreement with Transcontinental Gas Pipe Line Corp. a distance of 1400 miles to KeySpan's service territory in New York City. As a result of this transaction, the offshore producer/wellhead operator, pays the federal government a monthly royalty equal to one-sixth of the Gulf Coast sales price arrived at with KeySpan. The producer remits payment to MMS with MMS Form 2014.

Under this proposed program, KeySpan, in conjunction with the offshore producer, could change the price for the 8,200 MMBtu per day of the total 60,000 MMBtu per day to \$2.00 per MMBtu (or whatever "set trigger price" might be determined by the Secretary of Interior). This one transaction could lower the natural gas price for 54,000 LIHEAP and other prequalified low-income customers in New York.

This solution adds no net administrative burden or cost to either the offshore producer, the utility or the state LIHEAP administrator. The producer could simply indicate on the required federal royalty paperwork (a simple redesign of Form 2014 would be required) that a specified portion of the royalty gas was sold in-kind at the predetermined LIHEAP set trigger price to the producer's utility customer, who verifies the sale volume and price for audit purposes. The utility then transfers the price benefit directly to the pre-qualified low-income recipients via their monthly utility bills. LIHEAP incurs no additional administrative burden because it has already qualified the recipient for assistance.

Under this approach, the producer handles the sales transaction of in-kind royalty gas. The only additional administrative burden is MMS' audit of the transaction. By not having to add special purchase contracts, the utility can simply transport the gas under existing long-term arrangements.

The above approach is not the only solution to moving royalty in-kind gas to low-income recipients. A number of flexible options can be pursued that help address the concerns of various industry participants. For example, some utilities may not have the information systems infrastructure necessary to allow them to identify specific recipients and pass through the lower-priced royalty-in-kind gas. Additionally, it may make more economic sense to have the government purchase firm transportation directly from the pipelines or pipeline shippers in those few instances where short-term "released-capacity" transportation may be cheaper than the utility's underlying firm transportation agreements.

Enabling Legislation and Pilot Projects

This novel concept is not meant to become a long-term social welfare entitlement program. Rather, when spot market prices return to levels near the ten-year average (which could be calculated on either a NYMEX, regional, or citygate basis), the need for the program could be reviewed on a seasonal basis.

Enabling legislation is, however, needed to address the Mineral Leasing Act and the Outer Continental Shelf Lands Act to allow the Secretary of Interior to accept a price that benefits the low-income.

We must move quickly in order to implement a pilot program that will address the high natural gas prices

that are anticipated for this coming winter's heating season. Utilities could be selected for pilot programs in which each utility could tailor the concept to its own needs and requirements.

More than enough federal royalty gas exists to satisfy all of the low-income demand nationwide. The nation's top 25 natural gas utilities serve 52.5% of all residential consumers in the United States. Under the above-described "KeySpan" approach, one "deal" alone can "cover" the low-income needs behind one of the largest gas utilities in the country utilizing only 3/10ths of one percent of the available offshore federal royalty gas volumes. Imagine what 25 "deals" a month could do for other low- and fixed-income consumers! Auditing 25 transactions a month would be a nominal task for the MMS given the measure of benefit it would provide to recipients. MMS' cost to audit would be miniscule compared to the "up-to-ten-percent" cost of LIHEAP administration.

The Benefits

Important collateral benefits to this program are apparent beyond lowering the price of natural gas for low- and fixed-income households.

1. The proposed program could provide an additional benefit to the low-income in addition to increasing existing LIHEAP funds. This is best described by Karen Brown, current Chairman of the National Fuel Funds Network, who says in a letter (copy attached) that, "Additionally, in times of such crisis as last year, simply increasing dollars to be delivered through a finite and, in some cases, much outdated delivery structure such as LIHEAP is not fully effective. The LIHEAP program may be nearing its administrative capacity in terms of delivering significantly more dollars – especially without investing more dollars to improve such an infrastructure. Additional delivery mechanisms such as utilities would expedite delivering dollars to people in need."
2. By working in collaboration, producers, pipelines and utilities can direct more dollars to the needy by avoiding the "up-to-ten percent" administrative cost inherent in the LIHEAP program. As an example, if this federal royalty-in-kind (RIK) solution results in \$1 billion in benefits to LIHEAP customers, eliminating the 10% administrative charge adds another \$100 million to the bottom line for low- and fixed-income customers.
3. LIHEAP and similar programs could redirect a larger pro-rata share of their funds to conservation efforts as a result of the base cost of natural gas being addressed by this program.
4. The diversity of this approach allows for a greater level of understanding about how a "molecule of gas" travels from the wellhead to the burnertip. For example, utilities could provide informative leaflets with their bill that describe the program in simple, everyday terms, thereby helping to educate and raise the level of awareness among those customers who know the least amount about our industry and yet are impacted the most by price volatility.

Conclusions

If, as many industry experts indicate, natural gas prices continue to remain 30% higher than just one year ago, more and more individuals on low or fixed incomes will continue to seek energy assistance from state and federal programs. Under this proposed program, the Secretary of Interior has the option to decide if and when natural gas prices become high enough to warrant allocation of royalty in-kind gas to LIHEAP programs. If the Secretary so designates, producers, utilities and state LIHEAP organizations will not need

to scramble to introduce new programs overnight, but will have the flexibility to reduce the price of gas supplies designated for LIHEAP recipients.

While LIHEAP offers other energy assistance programs that can benefit from any additional dollars the federal government may allocate to them in times of high energy prices, 100% of the benefit of low-priced, in-kind royalty gas is passed on to LIHEAP recipients free of any additional administrative fees.

Requesting this Subcommittee's assistance in putting together the requisite enabling legislation is my reason for appearing here today. The efficiencies of this proposal and the benefits to all parties involved should motivate us to move forward.

#